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SUBJECT: Red Ink Permeates Austrian Campaign, Marking Break with Economic Reform Path

REF: (A) VIENNA 0969; (B) VIENNA 0965;
(C) VIENNA 0954; (D) VIENNA 0621

¶1. SUMMARY: Economists are concerned about pre-election spending proposals which combined with a proposed tax cut could drive up Austria's budget deficit from near balance to 2.5% of GDP (near the Maastricht limit). Parliament might even enact large spending increases before the September 28 elections, seriously limiting the next government's policy scope and marking the de facto end to serious economic reforms for the time being. END SUMMARY.

The Outset

¶2. Austria now has its highest inflation rate in fifteen years (ref A) and economic growth is projected to weaken to 2.2-2.3% (at best) in 2008 and 1.4-1.9% in 2009 (ref C). Blessed with strong tax revenues in 2006 and 2007, the outgoing government spent most of the extra income and only reduced the total public sector deficit from 1.5% of GDP in 2005 to 0.5% in 2007 (at a time when it could well have run a surplus). Unexpected 2008 revenues will be used for "anti-inflation" measures, a recent turn of phrase for spending programs (including reduced unemployment insurance contributions for low-income groups and moving the annual pension increase forward by two months to November 1). Even before the wave of pre-election spending, Vice-Chancellor and Finance Minister Wilhelm Molterer (OVP) announced that the GoA will be able to cut the federal deficit to 0.1% of GDP in 2010 with a small surplus thereafter, signifying that the GOA has abandoned the goal of a balanced budget over the economic cycle (in line with the EU's Stability and Growth Pact).

¶3. Relative to other Eurozone economies, Austria made major fiscal policy shifts from 2000 to 2006 including pension reform and a corporate tax cut. However, in the past two years, the SPO-OVP grand coalition failed to continue the reform agenda in such areas as streamlining government and administration, health care reform, and other measures to anchor long-term fiscal sustainability.

More Pork than Usual for Election Season

¶4. Coming at a time of voter discontent, the election campaign has led all major parties to propose ways to soften the impact of inflation through tax cuts and new spending. In July, Molterer opened pork season by proposing a thirteenth monthly family allowance, a higher nursing care allowance and a subsidized "Austria ticket" for all public transportation - estimated to cost EUR 550 million in all. Social democrats were sympathetic but needed their own package for campaign reasons, leading SPO Chairman and Transport

Minister Werner Faymann to terminate the coalition's parliamentary truce and present an SPO spending package: a higher nursing care allowance and thirteenth monthly family allowance (by and large compatible with the OVP), abolishing university student fees, extending from 2010 to 2013 the possibility for early retirement without cuts in pension payments (another step back from 2003/4 pension reforms), and cutting the VAT on food products from 10% to 5% - estimated total cost of EUR 1.3 billion. Since then, the parties have outbid each other on new spending, with cost estimates (including the income tax cut) as follows:

PARTY	PROPOSED NEW SPENDING
SPO	EUR 5.0 billion
OVP	EUR 3.8 billion
FPO	EUR 5.7 billion
Greens	EUR 7.5 billion
BZO	EUR 4.8 billion

Economists Sound the Alarm

¶5. Austria has done well since 2000 by pursuing liberal market reforms but remains in transition from a highly regulated economy with a large government sector to a flexible "social market" economy. Economists are concerned about the recent spiraling of campaign promises -- none of which qualifies as structural reform or true growth promotion -- and their negative potential impact on Austria's federal budget. Conservative senior economist Bernhard Felderer (head of the Federal Debt Committee) expressed concern that the spending promises could push the budget deficit to 1.5% of GDP in 2010, including the planned income tax cut even to 2.5% of GDP,

in which case Austrians have can expect a new wave of austerity measures.

Income Tax Cut in Jeopardy, VAT Tax Cut Problematic

¶6. There is broad consensus that Austria should lower and overhaul personal income taxes. Austria's tax quota is high (close to 43% of GDP) and the current system is unbalanced: 7.5% of salaried tax payers are responsible for 45% of total income tax revenues on wages while almost 43% pay no tax. Since 1990, personal income tax burden has fallen as a share of EU GDP (from 10.7% to 10.2%) while rising in Austria (from 8.3% to 9.3% of GDP). Austria has high taxes on labor income but low property and corporate taxes and is below the EU average for ecological taxes. Given election-related promises, there may be no money left for cutting income tax, in part because the outgoing GoA failed to free up budget funds by implementing administrative reform and streamlining levels of government (ref B).

¶7. Experts criticize the proposed VAT cut as costly (about EUR 1 billion), socially unbalanced, the wrong way to fight inflation and a measure that can hardly be reversed. Despite a legal requirement on firms to pass on tax cuts, many experts doubt that consumers will reap the full benefit of a VAT reduction in the form of lower prices, particularly given Austria's extremely high concentration among retail grocery chains.

COMMENT: Resting on Laurels While Reform Fades

¶8. Across the spectrum, parties are painting the next government into a corner by promising expensive new programs without new sources of savings or revenue. Even if only some of the proposed measures are implemented, the budget deficit could rise to 1.5% of GDP, which with the planned tax cut would mean a deficit of up to 2.5% of GDP (or higher in a recession). Expanding Austria's already large welfare state seems like electioneering rather than a coherent response to inflation. Austria's family allowances already total 3.1% of GDP - considerably above the OECD average of 2.4%. A bigger state will crowd out needed investments in R&D, restructuring, and other measures need to keep Austria competitive despite its high

wages and costs.

¶9. The end of Austria's economic reform decade is in the air. The bulk of new spending proposals - whether enacted before the election or soon afterwards -- would considerably pre-charge the next budget and limit the incoming government's economic policy scope. Moreover, the campaign has degenerated into a race to "buy votes" at the cost of long-term sustainability. The next GOA will have difficulty convincing markets that it can kick-start reform despite promising voters the contrary.

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